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Chairman Kevin J. Martin
Commissioner Michael J. Copps
Commissioner Jonathan S. Adelstein
Commissioner Deborah Taylor Tate

Federal Communications Commission
445 12th Street, Southwest
Washington, D.C. 20554

RE: MB Docket No. 05-311, Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as amended by the Cable Television Consumer Protection and Competition Act of 1992

Dear Chairman Martin and Commissioners,

FreedomWorks, an 800,000-member grassroots organization that promotes market-based solutions to public policy issues, has several concerns regarding the status of competition in the market for video programming and we encourage the Federal Communications Commission to consider these issues as it reviews the implementation of Section 621(a)(1) of the Cable Communications Policy Act. Established in July 2004 through a merger of Citizens for a Sound Economy and Empower America, FreedomWorks has consistently pursued policies that foster free-enterprise and competition. FreedomWorks has been actively involved in a number of regulatory issues and has been particularly interested in technological advances and changes in the marketplace that bolster competition and consumer choice. In such instances it is critical that the regulatory framework adapt to the realities of the marketplace so that consumers are not unnecessarily restricted in their

choices and the degree of competition in the marketplace is maximized. FreedomWorks urges the Commission to address, in particular, potential barriers to entry created through the franchising process in the market for video programming.

Video Programming and Customer Choice

Today's technologies have transformed the way we live, touching almost every aspect of our lives, from how we talk to others, to how and what we listen to, to what we watch and where we watch it. Cell phones, iPods, TiVos, and flat screen TVs are at the forefront of a technological revolution that is providing dramatic consumer benefits. While not as visible, the benefits go well beyond simple entertainment to such important areas as telemedicine and distance learning. Indeed, the entire technology sector is in the midst of a transformation: a number of cable companies and others—including Skype and GoogleTalk—are offering Internet telephony. Verizon, a traditional phone company, has introduced video programming services in Texas. The newly reconstituted AT&T and other phone companies also are poised to offer video services in a growing number of states. Going even further, cable stalwart Time-Warner has unveiled video over Internet in San Diego, and television over cell phones is becoming a reality through the efforts of MobiTV and VCast.

Unfortunately for consumers, one area that seems impervious to technological change is regulation. Despite advances in science and technology over the last 20 years, the high-tech world continues to labor under regulations last updated in 1996, when today's cutting-edge technologies were not even on the shelves. As a consequence, there is a disconnect between technology and consumer expectations on the one hand, and regulation on the other, with outdated laws hurting consumers by hampering the adoption of new technologies.

Even more troubling, incentives within the regulatory regime make it difficult to correct this divergence between technology and regulation. Technological advance constantly leads to new consumer goods and services. Yet regulations written for monopolists that no longer exist impede progress through artificial barriers and bureaucratic constraints. For decades, the goal of state and local regulators has been to regulate monopolies in an attempt to achieve economies of scale while avoiding the negative aspects of sole providers.[1] This world of regulated monopolies blurred the distinction between industry and government, with state and federal regulators having significant influence over such critical variables as output and price as well

[1] Kenneth E. Train, *Optimal Regulation: The Economic Theory of Natural Monopoly*, The MIT Press: Cambridge, Mass. (1992).

as the services and features offered to consumers. In addition, regulated industries proved to be ideal revenue collectors that allowed state and local governments to farm out tax collection in less than transparent ways. In this world, consumers bore the brunt of these regulatory policies: limited choices, above-market prices, and hidden taxes.

There have been attempts at both the federal and state level to close the gap between regulations and markets. Beginning with the break-up of AT&T in 1984, the industry and regulators have wrestled with Moore's law, or the notion that computing power grows exponentially, roughly doubling every 18 months.[2] These advances have reshaped the market, generating competition in unexpected places while providing consumers new and innovative products. In response, regulators have attempted to force-fit these changes into the Federal Communications Act, which was first passed in 1934.

What was once a segmented market with different regulated monopolists providing specific sets of services (e.g., wireline telephone service, wireless services, video services, and so forth) is now dynamic and competitive with all providers competing to provide consumers the triple play of voice, data, and video services. Digital technology has eliminated the borders between various products as messages, sounds, and images are reduced to bits of data—zeroes and ones that can carry virtually any information a consumer requires.

The transition underway can be seen in the realignment of providers in the marketplace. Cable companies are merging, as are major players in the telecommunications market. Time Warner and Comcast are seeking to divvy up the remaining assets of Adelphia, the cable giant that fell prey to scandal. On the telecommunications side, a new AT&T emerged from SBC's purchase of the old AT&T, and Verizon merged with MCI. Increasingly, competition is occurring across various technological platforms. Phone companies and cable companies are competing in the voice, Internet "data," and video markets, and new technologies are making wireless providers an increasing threat to both phone and cable companies. Major restructurings have occurred there as well, with Cingular acquiring AT&T Wireless, and Sprint merging with Nextel. At the same time, Alltel is divesting its landlines and Qwest is divesting its directories business.

A decade after the 1996 Telecommunications Act, technological convergence has altered the landscape significantly. Today's consumers have greater choice and more innovative products available at competitive prices. But these gains tend to be in those areas beyond the reach of regulation. For

[2] See Wikipedia at http://en.wikipedia.org/wiki/Moore's_law for a discussion of Moore's law.

example, consider the changes in wireless communications, perhaps the sector of the industry with the lightest hand of regulation. Prices have fallen, new services and plans have been introduced to accommodate all types of consumers, and today's phones continue to add new features at a rapid pace, from new voice mail and email options to cameras and MP3 players.

But just as the industry is re-inventing itself, governments must re-examine the regulatory framework to eliminate outdated laws that impede competition and delay improvements in functionality that consumers have come to expect. Several states are in the process of rewriting their telecommunications laws, with Texas already enacting sweeping reforms promoting competition and providing consumers a wider range of choices. At the federal level, both the House and Senate have introduced bills to reform the telecommunications sector. Much of this legislation focuses on the current fault line in the debate, which is cross-platform competition between the cable companies and telephone companies. The FCC should encourage efforts to modernize the regulatory regime to promote competition and increase consumer welfare.

THE REGULATION OF TELECOMMUNICATIONS

Since 1934, different titles within the Federal Communications Act have addressed different aspects of communications and the technology platforms upon which they operate. Title II of the Act was dedicated to oversight of the wireline common carriers, or the telephone companies providing point-to-point communications services. Title III was dedicated to broadcast technologies, first radio and then television as well. When cable television emerged much later, a new Title VI was established to govern its activities. This enabling legislation shaped the bureaucracy within the Federal Communications Commission (FCC), with individual bureaus creating independent silos of regulation for particular technologies.[3]

But in today's world, those technologies are no longer independent of one another. Cable companies have entered the voice market, telephone companies are poised to enter the video market, and cellular service companies compete with both landline telephone and cable companies for voice and Internet data services. In 2005, for example, the number of wireless subscribers outpaced the number of landlines in many states and is forecast to exceed total wireline service by 2006.[4] Specialized providers such

[3] See Jonathan E. Nuechterlein and Philip J. Weiser, *Digital Crossroads: American Telecommunications Policy in the Internet Age*, Cambridge, Mass: The MIT Press, 2005.
[4] Federal Communications Commission, Wireline Competition Bureau, Industry Analysis and Technology Division, *Trends in Telephone Service*, April 2005, Table 7.1, and the Yankee

as satellite and WiFi networks already compete with the others in video and Internet data services while Internet telephony providers are finding ways to use WiFi in lieu of the "last mile" service from telephone and cable operators.

It is not surprising, then, that phone companies have an interest in video programming. With new platform-based rivals like wireless and VoIP (Voice over Internet Protocol) as well as competing local exchange carriers (beneficiaries of the FCC's force-fed competition policies), traditional wireline service is no longer a safe regulated monopoly. As voice communications become commoditized, traditional phone companies are seeking new products and services. Without adding new lines of business, the prospects for a healthy recovery are limited. As one analyst put it, the local phone companies "see their land-line business as an ice cube melting in the sun."[5] Both Verizon and the new AT&T are aggressively investing in their networks with the hopes of providing a competitive alternative to existing cable companies.

As the nation's networks converge with the promise of a new world of communications for consumers, Congress must determine whether the existing siloed approach to regulation is creating unnecessary barriers to entry that hinder the necessary investment in broadband infrastructure. As cable and telecommunications companies make the transition from government sanctioned monopolists to competitive industries, regulators must abandon legacy notions of price regulation in favor of a broader vision of competition across platforms and networks subject to the discipline of consumer choice in a competitive market.

FROM AT&T TO AT&T

America's telecommunications industry began as a patent monopoly when Alexander Graham Bell patented the telephone in 1876. By the time the patent expired in 1894 almost 300,000 Americans owned a telephone. While this rapid growth far outstripped anyone's expectations, it was nothing compared to the growth that would come from competition. In the following decade more than 3 million Americans would own telephones, but the dramatic increase in competition posed new challenges because there was no

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Group, *Personal Wireless Calling Surpasses Wireline Calling: A Wireless Solution Update*, August 2005.

[5] Todd Dagres of Spark Capital, quoted in Lorne Manly and Ken Belson, "Calling Out the Cable Guy," *The New York Times*, November 27, 2005, http://www.nytimes.com/2005/11/27/business/yourmoney/27cable.html?ex=1290747600&en=d3ab13abfe4e9540&ei=5090&partner=rssuserland&emc=rss

system in place to allow customers of the various competitive phone companies to talk with each other.[6]

Rapid entry by competing phone companies created another problem that is now all too familiar to modern day municipal officials. With each competitor attempting to reach as many customers as possible, there was a tremendous increase in infrastructure construction by communications companies. A blight of wires and poles appeared in many major cities throughout the country.

Each of these problems—the need for companies to interconnect so customers could communicate, and the burdens associated with constructing new networks—led to government intervention. Today, it is the resolution of these two issues that is at the forefront of the debate over telecommunications reform. Importantly, the industry encouraged this intervention, with the largest companies hoping to stave off what they termed "ruinous competition" from new entrants. In effect, a bargain was struck early in the last century between the large incumbents and the government, embracing AT&T's plan for creating a rate-regulated world in exchange for a monopoly mandated and protected by the government.[7]

The problem of over-development led one court to observe "the streets are already lined with masts sustaining an intricate web of wires, actually or potentially charged with an electric current . . . . [N]o argument is requisite to show the inconvenience that might result if the number could be indefinitely increased . . . . [M]uch as they have multiplied in the past, we may believe that in the near future they will be still more numerous."[8] This fear of a city being overrun with telephone wires and poles combined with an 1866 federal law that granted telephone companies access to the public rights-of-way led cities to resort to higher-and-higher fees in an effort to reign in the onslaught of telephone development. While these fees began as an alternative form of land use control by municipalities, they soon evolved into a reliable and ever-increasing portion of municipal budgets. Indeed, some towns assert they generate a significant portion their general revenues through such fees. Thus, while a century ago many municipal officials might have welcome federal standards for limiting access to public rights-of-way, today municipal officials are loathe to relinquish the power and revenue that flows from their management of the rights-of-way.

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[6] Martin I. Hamburg and Stuart N. Brotman, *Communications Law and Practice* (New York: Law Journal Seminars-Press, 1995)..

[7] Alfred Kahn, *Economics of Regulation*, MIT Press, 1988.

[8] W. Union Tel. Co. v. City of Philadelphia, 12 A. 144, 145 (Pa. 1888). Photographs from the era show hundreds of wires crisscrossing the streets. See Edwin S. Grosvenor and Morgan Wesson, *Alexander Graham Bell*, New York: Harry N. Abrams (1997), pp. 120, 172.

The interconnection problem led to an evolving federal solution, but the principles set forth in the Kingsbury Commitment of 1913, specifically with regards to universal service, continue to form the cornerstone of modern communications policy. Under the Commitment AT&T agreed to connect non-competing independent telephone companies to its network and divest its controlling interest in the telegraph company, Western Union. The government endorsed AT&T's vision of one system that would provide universal service to everyone. Under this agreement dynamic and unorganized competition was subsumed by a regulated industry with regional telephone companies, and the concept of telephony as a natural monopoly began to take hold. The Communications Act of 1934, while never mentioning universal service, has been used to endorse the connection between universal service and AT&T's "natural monopoly" while establishing universal service as the foundation of our nation's telecommunications policy.[9] Arguably, the subsidies and distortions created in the name of universal service are one of the most significant deterrents to a more competitive and market-based telecommunications industry in the United States.

By the 1980s, the natural monopoly concept was wearing threadbare as numerous economic studies demonstrated that rather than protect consumers, the regulatory regime tended to benefit the incumbent phone companies at the expense of consumers. Finally, in 1984 a consent decree opened the long distance market to competition while breaking up AT&T. The first decade after the breakup saw price competition in the long distance markets leading to dramatic reductions in costs.[10] This was followed by the Telecommunications Act of 1996, which sought to push competition even further, with the goal of promoting greater competition in the local phone market. The Act opened the lines of incumbent local phone companies to new entrants at regulated rates. While this regime of managed competition did encourage new providers, mandated access at regulated rates reduced the incentives for capital investments required to upgrade infrastructure for the newest technologies. Regulations have also imposed significant costs on consumers. Economist Jerry Ellig estimates that the total burden of FCC telecommunications and broadband regulation is $105 billion annually in foregone services and higher prices.[11] That equates to an annual burden of almost $1,000 imposed on each American household.

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[9] Joseph S. Kraemer, Richard O. Levine, and Randolph May, *The Myths and Realities of Universal Service: Revisiting the Justification for the Current Subsidy Structure*, Progress and Freedom Foundation, January 2005.
[10] Robert W. Crandall, *After the Breakup: U.S. Telecommunications in a More Competitive Era*, The Brookings Institution Press, 1991.
[11] Jerry Ellig, "Costs and Consequences of Federal Telecommunications and Broadband Regulations," The Mercatus Center, George Mason University, February 2005.

The 1996 Act targeted specific technologies when attempting to promote competition. For example, competition with incumbent local phone companies was evaluated strictly in terms of additional providers using the local network. The number of new entrants, or competitive local exchange carriers (CLECs), was the measure of competition. Similarly, specific rules were established to determine whether the existing local phone companies, or incumbent local exchange carriers (ILECs), could enter the long distance market.

Today's wireline telecommunications market is represented by the remaining Baby Bells spun off from AT&T in 1984—Verizon, Qwest, AT&T, and BellSouth, along with hundreds of smaller independent telephone companies that were never part of the original AT&T system—competing with CLECs (the federally minted competitors with whom they share their networks) in the local market and dozens of independent network competitors in the long distance market. To survive, the wireline companies must also respond to threats from cross-platform rivals such as wireless and cable operators. In response, to such threats, the Baby Bells are looking to expand their own horizons, with a keen focus on the market for video programming.

The expanding scope of this market will have a significant impact on the regulatory regime. Today's marketplace is swiftly moving beyond voice and data transmissions and looks radically different than anything that policymakers could have envisioned a decade ago when the telecommunications laws were last updated. Comcast plans to have 15 million VOIP subscribers by the end of 2006, Verizon has obtained approval to offer its FiOS TV service in seven states, and wireless providers are beginning to offer video and broadband. As network platforms converge, competition is fundamentally redefined and it is essential that government regulations keep pace.

Microsoft's Live Communications Server 2005 offers a full suite of communications offerings from email and instant messaging to VOIP and video conferencing. AOL and Yahoo just announced plans to charge businesses to deliver certified commercial emails, allowing paying companies to ensure that the certified messages make it through SPAM filters and to their members. Google has launched a Chat service that promises to allow its members to email, instant message, and talk with each other, and there are even plans of expanding the service to allow their members to connect to the PSTN and talk with anyone who has a phone number.

Voice is not the only service facing a sea change of competition. Real Networks and Time Warner tested an IPTV solution that allows users to

watch cable television programming over their computer, making their cable service available anywhere with a laptop and a broadband connection. All of the major wireless carriers have launched video services, and many are beginning to offer live television programming. Yahoo has become a complete entertainment portal with exclusive clips from the hottest television shows and latest movies; they have even partnered with MTV to launch a new online reality series, IMU: I Miss You. Google recently launched a video service that many experts are predicting will mark the next evolution of video on demand—using the Internet as opposed to a cable box as the platform for distribution. And gaming appears poised to become the next "killer app" with sales for new video games like Halo 2 generating revenues that rival a blockbuster movie release. Sony and Microsoft both have included online gaming components for their next generation gaming consoles that allow gamers to play and talk with opponents throughout the world in real-time. Ironically, this communication capability threatens to redefine these gaming consoles as VOIP providers.

These dramatic changes demonstrate how bits and bytes have come full circle to reshape the market while redefining those who are subject to regulations originally designed for wireline competitors. The new market includes communications providers, application providers, content providers, and others vying for consumers. Undoubtedly, this competition will generate new business models and new services that will challenge regulators struggling to fit them into an outdated regulatory regime.

THE CHANGING WORLD OF CABLE TELEVISION

Cable television has become a significant player in the emerging information economy, offering not only video programming but high-speed Internet and telephony as well. Today, the industry offers service to over 98 percent of American households with a television, while claiming 61 percent of these homes as customers.[12] In 2004, revenues were estimated to be over $60 billion.[13]

Developed in the late 1940s as a means of providing broadcast programming to rural communities, cable television simply retransmitted local channels to households that were beyond the reach of broadcast television signals. At the start, cable systems were only capable of handling twelve channels, which subscribers received via coaxial cable. Typically referred to as Community Antenna Television (CATV), cable originated as a way to deal with the allocation of spectrum adopted by the FCC. To ensure

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[12] Federal Communications Commission, *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, FCC 05-13, February 4, 2005, p. 14.
[13] *Ibid.*, p. 19.

the broadcast capabilities of local communities, the FCC limited broadcast signal strength while providing spectrum to broadcasters who were geographically dispersed. The voids in coverage were filled by CATV.

Technology improvements yielded a capacity to transmit more content than local broadcasters could offer. By the 1960s cable providers began to view themselves as a competitor to local broadcasters, not simply a retransmission service. Cable television began to offer signals from other regions in addition to local broadcasts. In response to the new threat, local broadcasters sought and received new regulations from the FCC that limited the ability of cable providers to import signals from outside markets. Through the 1970s, these regulations were eased and new content was being generated specifically for cable. By the 1980s, cable networks such as CNN and ESPN had emerged, as well as subscription channels such as HBO and Cinemax. Newer technologies allow more channels and additional content, which has led to expanded services and the ability to tier subscriptions according to consumer demand.

Cable companies are regulated in a manner distinct from telephone companies, despite the fact that both platforms are converging to provide the same bundle of services. As mentioned earlier, the FCC places each of these platforms in a separate silo with its own set of rules and regulations. Whereas telecommunications services are regulated under Title II, cable companies are regulated by Title VI of the Communications Act, which was adopted in 1984. This legislation established a national policy for cable television while confirming state authority to regulate particular aspects of the cable industry. Much of the regulation occurs at the local level, where access to public rights-of-way is a primary concern.

In response to increasing prices and monopolistic practices, Congress passed the "Cable Television Consumer Protection and Competition Act" in 1992. This new legislation enhanced competitive entry into the marketplace, but also took a far more regulatory approach on other issues, introducing rate regulation, ownership restrictions, and mandated access for broadcast (must-carry rules). Chafing under price controls, investments in infrastructure dwindled along with investments in new channels of programming.[14]

[14] See Robert Crandall and Harold Furchtgott-Roth, *Cable TV: Regulation or Competition*, Washington, D.C.: The Brookings Institution Press, 1996. In addition, see Thomas W. Hazlett, "Prices and Output under Cable TV Regulation," *Journal of Regulatory Economics*, vol. 12, 1997: pp. 173-195, which finds that cable subscribership actually declined when rates were re-regulated and changes in investment incentives offset any gains due to lower regulated rates.

By 1994 it had become clear that rate regulation adversely affected quality and subscriber growth fell dramatically. This unintended consequence of rate re-regulation prompted the FCC to begin relaxing the price controls beginning in late 1994. The 1996 Telecommunications Act embraced competition as the appropriate means for ensuring that consumers receive the greatest value, and completed the removal of rate regulation and other regulatory burdens. In response, the industry flourished, investing $85 billion to update infrastructure and facilities, along with $69 billion in programming.[15]

Federal legislation also established the parameters for state regulators. At the state level, local franchising authorities can enforce the FCC standards for regulating the basic tier of cable channels. These city, local, or state authorities also have oversight over quality of service and franchise fees, which are paid in exchange for the right to offer cable service. While basic cable service falls under certain regulatory restrictions, anything above the basic tier is not subject to price regulation, and cable companies establish their prices in an open market.

Today, there are over 33,000 cable service franchises.[16] As made clear by the 1992 Act, local franchising authorities cannot grant exclusive franchises, opening the door to "over-builders"—competing cable operators that enter markets where cable franchises already exist. Digital Broadcast Satellite (DBS) providers have emerged as an additional source of competition, and phone companies and Internet Service Providers such as Yahoo or Google could offer video programming to provide consumers an even greater choice. Currently, satellite is the largest competitor, but it is not a perfect substitute. It has made inroads and now accounts for 25 percent of the 92 million households subscribing to a video programming service.[17] (See Figure 1) However, satellites are a different technology, with different applicability, particularly in dense urban areas where it may not be feasible to receive satellite signals. True wireline competition, therefore, remains limited in scope. Yet a study conducted by the U.S. General Accounting Office found that in the 2 percent of the market where there are competing cable services, prices are 15 percent lower than in similar markets where no

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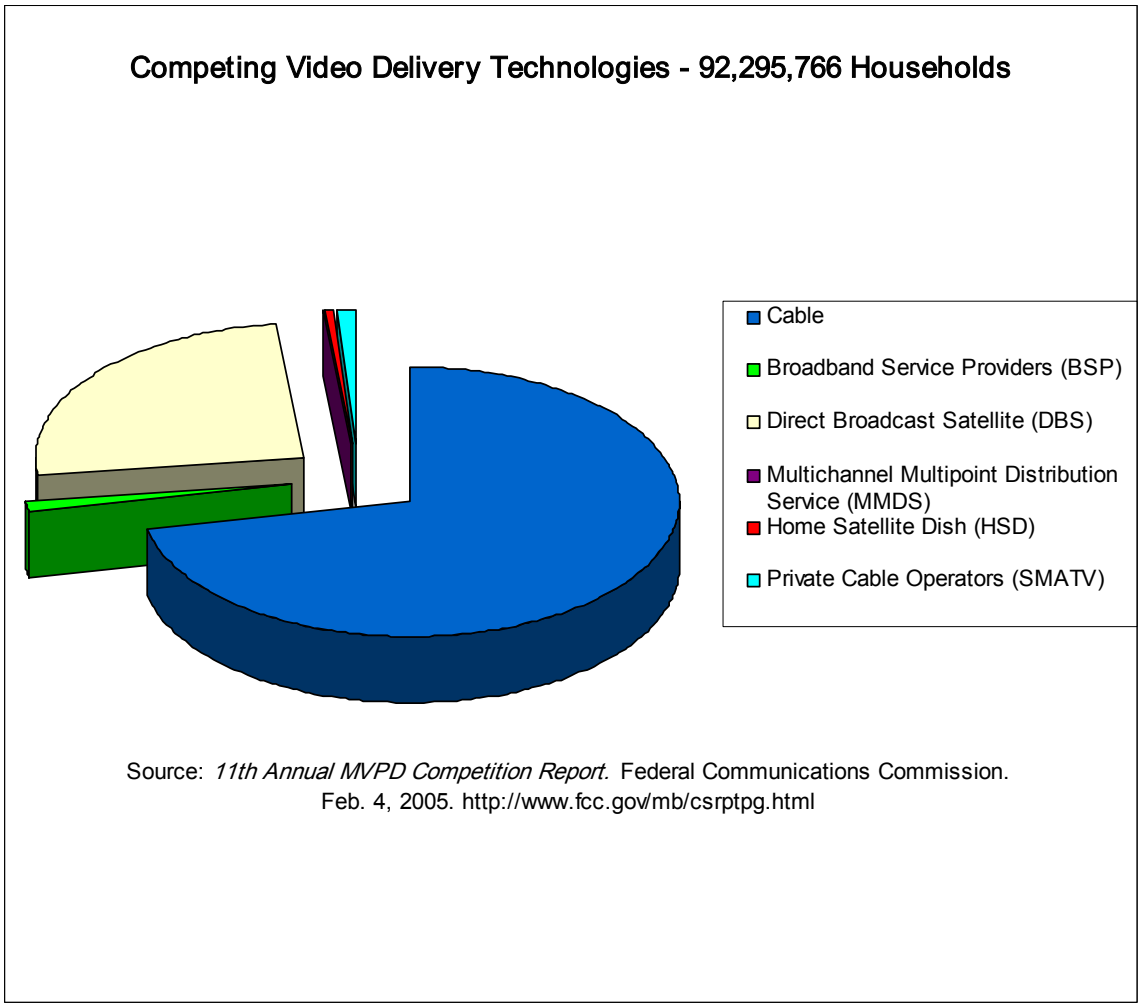
[15] National Cable and Telecommunications Association, "The Video Market is Fully Competitive: Almost 26 Million Consumers Now Subscribe to Cable's Competitors," July 24, 2004.

[16] Federal Communications Commission, Notice of Proposed Rulemaking, "Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as amended by the Cable Television Consumer Protection and Competition Act of 1992, MB Docket No. 05-311, November 3, 2005, footnote 28, p. 4.

[17] Federal Communications Commission, Annual Assessment of the Status of Competition, *supra*, 2005.

competition exists.[18] Analysis of competition in the few markets where a phone company has entered the video programming market provides similar findings. One report found "the rollout of Verizon's FiOS service in select markets has elicited thinly advertised, yet highly competitive pricing responses [from] incumbent cable providers."[19]



Source: *11th Annual MVPD Competition Report.* Federal Communications Commission. Feb. 4, 2005. http://www.fcc.gov/mb/csrptpg.html

Figure 1

Network and infrastructure upgrades allow cable providers to offer advanced services, such as high-speed Internet access and Internet telephony that make it difficult to distinguish a cable company from any other telecommunications company. Moreover, a recent Supreme Court decision makes clear that cable modems are regarded as an "information service," which means that even though they may compete directly with traditional

[18] U.S. General Accounting Office, *Telecommunications: Wire-Based Competition Benefited Consumers in Selected Markets*, GAO-04-241, Washington, D.C., February 2, 2004.
[19] David W. Barden and Douglas S. Shapiro, "Battle for the Bundle: Consumer Wireline Services Pricing," Equity Research, Bank of America, January 23, 2006, p. 9.

wireline telephone companies, they will not be bound by legacy regulations such as interconnection mandates that have plagued investment in telecommunications.[20] Today, cable companies provide high-speed broadband connections for more than 18 million customers and telephone service to another 3.5 million.[21]

Despite the efforts of the Bell companies, cable companies currently enjoy a head-start in the emerging market of bundled services for voice, data, and video. Cable companies have a large advantage in terms of the number of high speed broadband connections.[22] Much of the recent revenue growth in the cable industry was derived from offering advanced services such as high-speed internet connections.[23] Overall, cable companies provide service to over 66 million households and are working aggressively to expand their markets for high-speed Internet and telephony services.

WHEN REGULATIONS CONFLICT

Perhaps the primary regulatory distinction between local phone companies and cable system operators is the degree of regulatory authority retained by local governments. Both services require access to public rights-of-way, and technological convergence is making it more difficult to draw meaningful distinctions between these two industries. Nonetheless, they are very different from a regulatory perspective.

Regulatory authority over the telephone systems dates back to the turn of the last century. At that time, state regulation, primarily through public utility commissions governed the actions of telecommunications companies. Because the law views local governments as the owners or trustees of public rights-of-way, local government had the authority to recover the costs for telecommunications companies using rights-of-way. Yet, regulatory authority was vested in federal and state governments. Local authorities, in essence, only managed access to public rights-of-way.[24]

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[20] National Cable & Telecommunications Association et al. *v.* Brand X Internet Services et al., 2005 US LEXIS 5018 (US, June 27, 2005)

[21] Federal Communications Commission, Annual Assessment of the Status of Competition, *supra*, 2005, paragraphs 46 and 50.

[22] *A Nation Online: How Americans Are Expanding Their Use of the Internet*, U.S. Department of Commerce, February 2002, p. 35.

[23] Federal Communications Commission, Annual Assessment of the Status of Competition, *supra*, 2005.

[24] Kent Lassman, "Franchising in the Local Communications Market: A Primer and Discussion of Three Questions," Progress on Point, Release 12.9, Progress and Freedom Foundation, June 2005.

The cable industry emerged much later and under a different set of rules. Whereas the FCC was expressly created to regulate telephone service, it was only able to obtain authority over cable through ancillary jurisdiction. Early in its development, cable was viewed merely as an extension of broadcast television and treated as such by the FCC. The only political support for regulating cable emerged from broadcasters who became increasingly threatened by the video programming offered by cable. In fact, it was only in 1966 that the FCC established rules to cover all cable providers, and these rules were affirmed by the court in *United States v. Southwestern Cable Co.*, which found that the FCC needed authority over cable companies to "assure the preservation of local broadcast service and to effect an equitable distribution of broadcast services among the various regions of the country."[25]

None of the cable companies had a dominant national presence, and, in fact, less than half of the country even had access to cable television service. Consequently, cable regulations had their origins in demands made by broadcasters, a far more organized interest group with a strong national presence. Early cable regulation acted more as a restraint on their entry into the market as a competitor to the incumbent broadcasters. As the cable industry evolved and grew, its political strength grew as well, allowing cable providers to reverse their regulatory fortunes by the 1970s at both the state and federal levels.

As a result, federal policies have primarily dealt with the relationship between cable and content providers (retransmission consent, must carry rules, and so forth). Since cable was not seen as a necessity in the same manner as telephone service, provisioning mandates and regulations were primarily left to the localities.

Regardless of the level of regulation, universal service was a key concern for regulators. In telephony it was federal regulators working in conjunction with state public utility commissions to assure statewide coverage. In the cable industry it was municipal officials negotiating community build-out requirements as conditions for granting an exclusive cable franchise. It should be noted that these build-out requirements were not mandated by federal statute; they emerged through franchise negotiations between local franchise authorities and cable operators.

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[25] United States v. Southwestern Cable 392 U.S. 157, 178 (1968), see also Federal Communications Commission, "Cable Television Fact Sheet," June 2000. Available at http://www.fcc.gov/mb/facts/csgen.html.

These competing policy models resulted in two networks that are almost universally available throughout the United States. Both are capable of offering a complete suite of communications products including voice, video, and high speed Internet. Unfortunately, companies are unable to use their networks to their full potential and more importantly, customers do not enjoy the benefits generated by competition, because zealous regulators are attempting to misapply legacy rules intended to regulate monopolies to competitive services and networks. The result has been billions of dollars in regulatory costs and delays in expanding the choices available to consumers in the marketplace.

Given the new opportunities for competition, the old regulatory rationale is no longer relevant to this new marketplace in communications. The franchising process continues to keep new technology out of the hands of ordinary Americans while reducing choice for video programming. As a consequence, cable is still dominated by monopolistic providers with local franchises.

THE (NON)-COMPETITIVE IMPACT OF FRANCHISING

For the most part, the two regulatory regimes of cable and telephone service worked independently of one another. Yet in recent years, converging technologies have put the two on a collision course. Local franchising authorities are seeking to expand their reach to include any new entrants in the video programming market, including phone companies who already gain access to public rights of way through state laws. They also have sought to exercise greater control over cable system operators who offer telephone service, which would expand the definition of gross revenue and, consequently, local government revenues. In this instance, however, the courts have intervened to curtail their authority.

Local governments dominate the video programming regulatory regime through the use of franchise agreements. Cable system operators are granted a special privilege, or franchise, to use the public rights-of-way in exchange for agreeing to provide specific services for the local government. Franchise agreements provide a wide degree of discretion for local franchising authorities, including the ability to collect franchise fees up to 5 percent of a cable company's gross revenue from video programming. Local franchising authorities assert that any new providers of video programming that require access to public rights of way must apply for a franchise as well, despite that fact that local phone companies already have access to public rights-of-way under terms established for providing telephone service.

The primacy of local governments dates to the earliest days of cable, but there was always a tension between local authority and FCC authority. This relationship was formalized in the Cable Act of 1984, which acknowledged the primary role of local governments in granting franchises and implementing the Act while establishing federal primacy with respect to setting national policy and clarifying the role of the FCC as the ultimate arbiter of interpretation. Since then, legislation has refined the roles of each party. Importantly, federal legislation prohibits local franchising authorities from granting exclusive franchises in an effort to promote greater competition and keep downward pressure on prices. In addition, as made clear in the 1992 Act, a franchising authority "may not unreasonably refuse to award an additional competitive franchise."[26]

Nonetheless, the existing franchising process can reduce competition by delaying entry, leaving consumers facing higher rates. In fact, cable companies have recently announced an additional increase in prices, with prices increasing by as much as 6 percent in some areas.[27] Annual price increases much higher than the CPI are the norm for cable. (See Figure 2.)

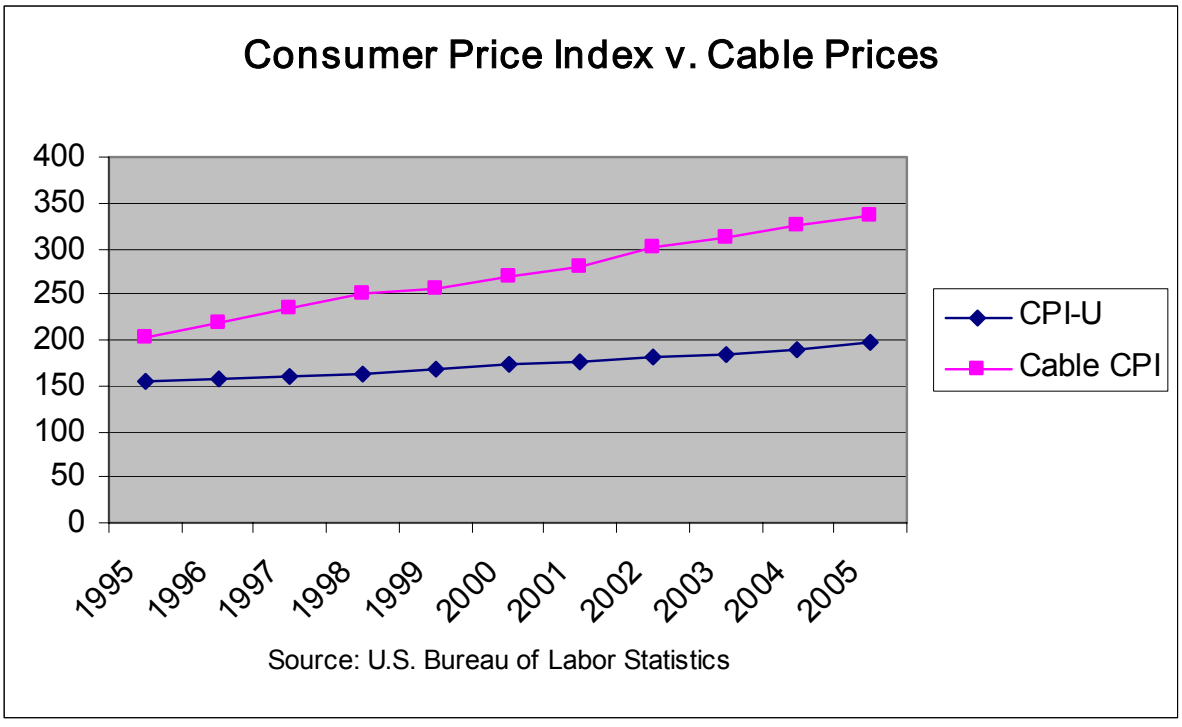

Figure 2

[26] Section 621(a)(1) of the 1934 Communications Act, 47 § 541(a)(1).
[27] Peter Grant and Dionne Searcey, "Cable Rates to Increase as Much as 6 Percent," *Wall Street Journal*, December 1, 2005, p. D1.

Application Process or Barrier to Entry? Under the current law, franchising is a costly multi-step process that can require a considerable amount of time and impede the ability of new entrants such as phone companies or Internet Service Providers from entering the market. The costs often begin with application fees that impose burdens on new entrants before the negotiations even begin. The request for a franchise then starts a proceeding that includes an assessment of community needs and interests. This may require public hearings, studies, and audits. The local franchising authority may issue a staff report that summarizes the findings. Once completed, the next step is for the local franchising authority to produce a demand document that requires the potential franchisee to respond in detail to the specific needs and interests identified by the local franchising authority.

Quite often the needs and interest extend beyond quality and scope of service. The Cable Act allows local franchising authorities to ask for significant investments in local government, including building "institutional networks" for schools and government buildings as well as providing channels for public, educational, and government (PEG) use and the studios and equipment for those channels. Potential franchisees are commonly asked to provide additional resources to localities for activities that have nothing to do with video programming. These requirements can be costly and may lead to another round of negotiations before the franchise agreement can be finalized. If the franchise is denied, an additional administrative proceeding, replete with public hearings is initiated. Should the franchise be denied again, the franchisee may turn to the courts to challenge the determination.

Besides the direct costs imposed on those considering entry, the franchising process also provides incumbent cable providers an opportunity to react to the potential competition. Not only are the new entrant's plans announced, but the incumbent also has an opportunity to monitor and affect the negotiations. In fact, in some states this influence has been set into statute, with laws that require any new entrant to match the requirements established initially for the incumbent. In the 1980s, "level playing field" laws emerged that prohibited municipalities from granting licenses to additional cable television operators "without imposing franchise requirements as 'burdensome' as those levied on the first entrant, and typically requir[ing] formal public hearings to determine the impact of the new rivalry."[28] While these laws purported to establish regulatory symmetry and promote the public interest, the ultimate effect was to limit competition

[28] Thomas W. Hazlett and George S. Ford, "The Fallacy of Regulatory Symmetry: An Economic Analysis of the 'Level Playing Field" in Cable TV Franchising Statutes," *Business and Politics*, vol. 3, no. 1, 2001, p. 22, available at http://mason.gmu.edu/~thazlett/pubs/the_fallacy_of_regulatory_symm.pdf.

to the detriment of consumers. The authors of one study note, "As a matter of firm strategy, pursuing a faux symmetry in regulation can successfully divert policymaker and administrative processes from promoting competitive entry. The success of incumbent cable suppliers in enacting LPF [Level Playing Field] statutes in key cable battleground states is notable."[29]

Clearly, franchising is an arduous process that slows entry into the market for video programming. A simple survey of the case law devoted to franchising suggests that the process can be burdensome and delay entry into a market undergoing rapid technological change. With more than 33,000 franchises nationwide, the entry process can be daunting. Fortunately, Congress is preparing to overhaul our telecommunications laws to bring regulation into the 21st century and the FCC should encourage efforts to develop a national solution to questions of franchising. As Congress seeks an appropriate regulatory balance, it is useful to consider the motivations that underlie our existing regulatory frameworks.

Build-out or Bypass? Build-out requirements and commitments can pose potential barriers to entry. Typically, cable companies want any new competitors to rapidly build out to the same footprint as the cable franchise before they can provide service. Such requirements reduce incentives to invest in infrastructure by imposing new regulatory burdens on any potential competitor. A recent study suggests that build-out requirements actually harm consumer welfare by reducing incentives to enter markets in the first place. Moreover, the authors note that build-out requirements can hinder deployment to lower income households by creating incentives for bypass that are greater for less profitable communities.[30]

Cable's call for any new entrant to be required to build out to the entire existing cable franchise before it can service one new customer is an attempt to impose legacy regulations on the emerging new market. But today's market is different. New entrants make investments with no guaranteed rate of return; they do not have a monopoly that ensures they will recoup their costs. They must compete with incumbent cable companies as well as satellite providers. Moreover, today's calls for equal footprints ignore the realities of build-out in the cable industry. First, cable operators were often given decades to achieve full build-out—typically under conditions of monopoly or near monopoly—and there were usually area density parameters below which no build-out was required. Second, telecommunications

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[29] *Ibid.*, p. 43.

[30] George S. Ford, Thomas M. Koutsky, Lawrence J. Spiwak, "The Impact of Video Service Regulation on the Construction of Broadband Networks to Low-Income Households," Phoenix Center Policy Paper No. 23 (September 2005).

networks are not necessarily congruent with cable franchise areas. One telecommunications network may cover several franchise areas, requiring multiple applications to achieve a similar footprint.

Given that the market is no longer a monopoly, it makes little sense to apply the old rules to new entrants. Build-out for a protected monopoly may have made sense, as there were no competitors to affect the process. In a competitive marketplace, strategic behavior by incumbent companies can thwart the efforts of new providers. It is unclear, therefore, what social policies are furthered by a demand that new competitors also build to the same footprint, especially if existing providers are not extracting monopoly rents. Moreover, for an industry to assert that new entrants must have access to their customers before they enter the market raises questions about their ultimate motives. Typically, firms protect their customer base and would strive to keep them beyond the reach of their competitors. In this case, calling for an equal footprint simply may be an attempt to raise the costs of potential rivals rather than a genuine concern for consumer welfare.

The FCC and state regulators understood the problems of legacy regulations when seeking to promote competition with telephone networks. In this instance, new competitors were granted freedom to provide service anywhere on the network. Competing local exchange carriers and cable providers have the flexibility to enter any markets they choose. This policy was implemented to promote the public interest by expanding competition. By contrast, franchise requirements impede competition in ways contrary to the public interest. Franchising laws also hinder the administration's stated objecting of increasing broadband deployment by reducing incentives to invest in the networks required to provide high-speed Internet access.

Video Programming Providers or Tax Collectors? Another issue impeding entry into video programming is the revenue structures used by local governments. Local franchising authorities have relied on the revenues generated through franchises and are often reluctant to abandon this lucrative system. In many localities, the revenues generated by franchises are an important component of the local budget. One town for example claimed that such fees account for 14 percent of local revenues.[31] There is nothing in the Cable Act that requires local franchising authorities to allocate these resources for activities related to video programming or rights-of-way management. In many instances, these revenues are simply added to the general fund.

[31] Cited in Kent Lassman, "Franchising in the Local Communications Market: A Primer and Discussion of Three Questions," The Progress and Freedom Foundation, June 2005.

This highlights a fundamental problem with existing laws. Namely, the old world of regulated monopolies intertwined the functions of government and industry. Rate regulated utilities were often called upon to provide public services or pay specific fees to the local government, which granted these companies full authority to pass these costs on to their customers. In essence, the regulated industries became tax collectors. While this may have been convenient for local governments, it raised serious questions about taxation. These questions will only become more difficult as new providers and technologies enter the market in ways that defy previous definitions of taxable activities.

Ideally, taxes should be transparent and avoid altering the behavior of individuals or firms. Farming out revenue collection to quasi-public entities reduces the visibility of taxes and now, with new technologies available in the marketplace, it is clearly distorting investments in the marketplace. In the current market, for example, DBS providers do not pay local franchise fees while cable providers do, even though from the consumer's perspective there is very little distinction between the video programming provided.

While taxation and social welfare are important decisions are important issues in every community, the tradition of mixing these goals with economic issues has reached a point where it is having an adverse impact on consumers. Ideally, questions of taxation and social welfare should be dealt with through the legislative process. Franchising questions, on the other hand, may be more appropriately addressed as questions of rights-of-way management in a competitive market. At the same time, it has been amply demonstrated that consumer welfare is maximized by allowing competition in the marketplace.

Consumers would benefit from increased choices and new technologies. As taxpayers, they would have greater control over questions of taxes and spending if the local officials debated openly debated questions of revenue. Rather than additional PEG channels or institutional development that they ultimately pay for in their cable bills, voters may see more pressing local needs such easing traffic congestion or strengthening crime enforcement. Alternatively, voters may prefer lower tax burdens that leave additional income to spend on their families. These are fundamental questions of any political system, and as such, deserve to be discussed publicly. When it comes to the question of who can and cannot offer video programming, the real goal should be customer choice.

In short, the market has changed, but both incumbent providers and local franchising authorities have a vested interest in preserving the old system. Cable providers enjoy limited competition while local governments

generate a source of revenue. Proponents of the status quo typically point to the existence of satellite systems and over-builders to note that the market is, in fact, competitive. Although over-builders remain a relatively small percentage of the market, DBS providers have managed to capture 25 percent of the market, and it is worth noting that because DBS providers do not rely on local rights of way, they have evaded many of the burdensome state and local regulations.[32] But asking if there is competition is a different question than whether barriers to entry exist. Institutional networks, rapid and full-area build-out, and other demands that cable authorities seek are one form of barrier to entry. The litigation-intense franchising procedures are another regulatory barrier to entry. Removing unnecessary regulatory burdens provides opportunities for even more customer choice, which enhances innovation while increasing consumer welfare.

THE COMPETITIVE ALTERNATIVE

The legacy of rate regulation and natural monopolies is a poor reference point for future policy. Old notions of regulated utilities are already impeding competition and deployment of new technologies. The regulatory framework continues to rely on theories of public utility regulation, where monopolists are allowed to operate under some form of price regulation while being allowed to recoup their capital investments and generate a "fair" rate of return for their investors. Alternatively, in the case of cable, franchises are granted for providing service in the public interest.[33]

Outdated regulations treat similar services completely differently based on the type of provider offering the service. Consider high-speed broadband connections, for example. From the consumer's perspective, the distinctions between DSL service by a phone company and cable modem service from their cable provider is not that significant. Yet DSL providers, until recently, faced a significant degree of regulation in the wholesale market that cable providers have been able to avoid completely. Such market distortions may explain why cable modems have a significant advantage in the market for high-speed connections. Similarly, DBS video programming from companies such as DirecTV has made substantial inroads in the market while avoiding the cumbersome franchising process.

As technologies converge and these services come to look more and more alike, these regulatory disparities will become even greater. At some

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[32] Robert Sachs, "Statement to Progress and Freedom Aspen Summit," National Cable and Telecommunications Association, August 2002, available at http://216.239.51.104/search?q=cache:YgtN4Ucrzb8J:www.ncta.com/press/press.cfm%3FPRid%3D291%26showArticles%3Dok+dbs+regulation+franchise&hl=en.

[33] Kahn, 1988, *supra.*

point, lawmakers must disentangle the various objectives of communications policy in order to redefine both the market and government priorities. Perhaps most significantly, universal service policies must be re-examined in light of new market competition. Many of today's market distortions are a direct result of universal service requirements that are clearly out of place in today's marketplace. In the earlier world of regulated monopolies, it was politically expedient to use cross-subsidies to keep residential rates and rural rates low while charging higher prices for business and urban customers.[34] Yet in a market with new entrants and cross platform competition, cross-subsidy schemes become unworkable.

Franchising is another area that must be carefully reviewed. Franchises were previously granted in exchange for an agreement to provide service to the community, including public interest provisions. In a competitive market, new entrants not subject to such provisions enjoy a competitive advantage over their rivals. The ideal solution would be to remove the market distortion. Unfortunately, in many states and at the federal level, lawmakers are seeking to expand the regulatory burden as a means of leveling the playing field. This has been the case in most initiatives to reform the franchising system. All proposals, for example, extend the taxes of 5 percent of gross revenue to all providers of video programming using public rights of way, as well as requirements to provide public, educational, and government access channels. Although the application process is clearly streamlined by shifting to one statewide franchise, the franchise fee remains a distortion to market activity. Not only does this raise the costs of deploying new technologies, but it continues to entwine tax policy with regulatory policies designed to promote consumer welfare. A more effective approach would shift away from franchising to rights-of-way management.

Changing technology leads to changing behaviors. Local officials must acknowledge those changes and realize a once stable revenue stream may vanish altogether when a new technology emerges. As the digital frontier expands and ISPs such as the new Brightcove enter the video programming market, the revenue base becomes even weaker, since this provides consumers a non-taxed alternative to franchised providers (whether at the state or local level). However, a recent study by the General Accounting Office (GAO) rises to the defense of local and state taxing authorities, claiming that a tax on Internet Service Providers offering video programming would not violate the Internet Tax Moratorium passed by Congress.[35] Others, however, disagree with the GAO's position, claiming the legislative

[34] Robert W. Crandall, 1991, *supra.*
[35] General Accounting Office, "Internet Access Tax Moratorium: Revenue Impacts Will Vary by State," AO-06-273, January 2006.

history makes clear that such a tax would violate federal legislation. Either way, this dispute demonstrates the need to sever the link between questions of technology and questions of taxation.

CONCLUSION

Today's video programming market remains mired in yesterday's laws, taxes, and regulations—all of which were created to govern a world that no longer exists. Any reforms must acknowledge the nascent competition among various providers of telecommunications services. Rather than establishing specific regulatory regimes for specific technologies, a more effective approach would focus on promoting competition among all providers. The market no longer consists of cable companies, wireless companies, local phone companies, and long distance companies. Digital technology has created a market where all providers transmit data to consumers who are indifferent to artificial distinctions in outdated regulations.

Modernizing our communications networks has important implications for both consumers and regulators. For consumers, this is an opportunity to expand choice and innovation. New high-speed fiber networks can deliver consumers state-of-the-art video programming over phone lines that would compete directly with local cable companies. Not only can these networks provide hundreds of channels of programming, they also have the capability to offer time-shift capabilities (e.g., DVRs or video on demand) that offer consumers greater control over their video technologies. Cable companies have already crossed into video and data services, and are investing in billions in state-of-the-art networks. Looking forward, competing networks can transform the communications, providing improved access to video entertainment and music, as well as providing data service as well as traditional telephone service. With phone companies in the video market and cable companies offering phone service, consumers can reap the benefits of head-to-head competition that will spur innovation while keeping prices in check.

For regulators the issue is more problematic; it has become a defining issue of how and why they regulate. Typically, economic regulation was justified as a means of controlling monopolistic behavior in a non-competitive market while capturing economies of scale. In today's market, however, it is difficult to justify that regulatory model because technology has created a market that can support multiple providers. Where the entry barriers are low enough, that has happened. Over-builders and DBS providers have made some inroads, and the deployment of high-speed fiber optic networks will allow broadband providers and phone companies to enter the video programming market. Cable companies are already offering advanced

services that include Internet telephony, all of which makes it hard to define this industry as a monopoly in need of regulation. In fact, at this point, the biggest entry barriers are the laws and regulations that prohibit new entrants from serving consumers. The solution, as with all entry barriers, is to remove them.

There is another issue that has given the incumbent cable companies a powerful ally—local government. More concerned with revenue than efficiency, many local governments are opposing changes to the regulatory regime that would facilitate new entry. Franchise fees generate more than $2 billion in revenues that are typically passed on to consumers. It is a convenient way to levy a tax without calling it a tax. Should competition erode this base, any revenue shortfalls would have to be made up elsewhere, leaving local governments to collect revenues more transparently, which means putting such decisions before the taxpayers. To avoid such fights over revenue, local governments will be a formidable challenge in any reform effort. Already the National League of Cities has alerted Congress of their critical role in the process, wrapping their revenue problems in concerns over the security of vital infrastructure.[36] But other experts estimate that full competition by franchisees will increase local franchise revenues as a result of attracting more subscribers and pulling some subscriber share from the DBS operators, who currently pay no local franchise taxes. One study suggests local revenues from franchise fees would increase by as much as 30 percent.[37]

The challenge for the future is significant, particularly for regulators. Clearly the vertical silos of the 1934 Communications Act are straining to incorporate new technologies and services. Cross-platform competition has become far more important for consumers than regulatory mandates about competition. But bureaucratic inertia makes change difficult. As Nobel laureate Ronald Coase noted in his discussion of the FCC in 1966, "However fluid an organization may be in its beginning, it must inevitably adopt certain policies and organizational forms which condition its thinking and limit the range of its policies. Within limits, the regulatory commission may search for what is in the public interest, but it is not likely to find acceptable any solutions which imply fundamental changes in its settled policies."[38]

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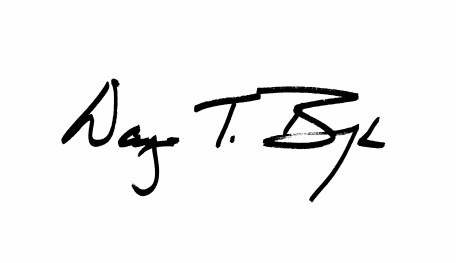
[36] Letter from National League of Cities to Chairman Stevens of the Commerce, Science, and Technology Committee, U.S. Senate, http://www.nlc.org/content/Files/Telecom%20-%20Stevens%20and%20Inouye%20Letter%2006%2009%2005.pdf.

[37] George S. Furd and Thomas M. Koutsky, "Franchise Fee Revenues after Video Competition: The 'Competitive Dividend' for Local Governments," Phoenix Center Policy Bulletin No. 12, November 2005.

[38] Ronald Coase, "The Economics of Broadcasting and Public Policy," *American Economic Review*, 1966, reprinted in Paul W. MacAvoy (ed.), *The Crisis of the Regulatory Commissions*, New York: W.W. Norton & Company, (1970).

But at the end of the day, this is a debate about choice—or the lack thereof—in a market that should be competitive by any measure. Consumers understand the importance of choice. New technologies are expanding those choices and the only thing standing in the way of progress are outdated franchise laws and regulations. Customers should not be taken for granted. Today's market is not a monopoly, so it makes little sense to demand everybody play by rules established to control monopolistic behavior. True, there should be a level playing field, but that playing field is an open and competitive market that forces all providers to compete for their customers.

Respectfully submitted,



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